PENSION MANAGEMENT OVERSIGHT COMMISSION

Legislative Services Agency
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MEETING MINUTES[1]

Meeting Date: September 11, 2008
Meeting Time: 12:30 P.M.
Meeting Place: State House, 200 W. Washington St., Supreme Court Chamber
Meeting City: Indianapolis, Indiana
Meeting Number: 2

Members Present: Rep. David Niezgodski, Chairperson; Rep. Win Moses; Rep. Woody Burton; Rep. Rich McClain; Sen. Dennis Kruse; Sen. Karen Tallian; Sen. Robert Deig; Steve Meno; Kip White; Randall Novak; Matthew Buczolich.

Members Absent: Sen. R. Michael Young.

Representative David Niezgodski, Chairperson, called the second meeting of the Pension Management Oversight Commission (Commission) to order at 12:40 p.m. The Commission recited the Pledge of Allegiance and observed a moment of silence in memory of September 11, 2001.

Divesting Indiana's Public Pension Funds from Investments in Terror Sponsoring States (HR 108)

Christopher Holton of the Center for Security Policy addressed the Commission and urged

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[1] Exhibits and other materials referenced in these minutes can be inspected and copied in the Legislative Information Center in Room 230 of the State House in Indianapolis, Indiana. Requests for copies may be mailed to the Legislative Information Center, Legislative Services Agency, 200 West Washington Street, Indianapolis, IN 46204-2789. A fee of $0.15 per page and mailing costs will be charged for copies. These minutes are also available on the Internet at the General Assembly homepage. The URL address of the General Assembly homepage is http://www.in.gov/legislative/. No fee is charged for viewing, downloading, or printing minutes from the Internet.

that Indiana's public pension funds adopt a policy that requires the divestment of stock of companies that do business in countries that support terrorism. The targeted countries are Iran, Syria, North Korea, and Sudan.

Mr. Holton said that over $200 billion is currently invested in the stock of publicly traded companies that do business in terrorist countries. These companies are all foreign owned, because federal law already prohibits American companies from doing business in these countries. Mr. Holton added that he is not suggesting that the pension funds intentionally support terrorism, but investing in the stock of these companies sends a message of legitimacy and provides revenue that enables terrorism. He suggested that pension funds should at least require the investment fund managers to disclose any targeted companies that are contained within the invested funds.

Mr. Holton further stated that this is not a federal or foreign relations issue; it is an ethical issue. The federal government's position is that whether a public pension fund invests in companies that do business in terrorist countries is an investment policy decision for the individual pension fund. He said that terror free investment policies work, using South Africa as an example, and that there is no evidence that such a policy hurts investment returns or is administratively expensive.

In response to Commission members' questions, Mr. Holton suggested that any divestment that occurs should be phased over a period of years to minimize the disruption to the pension funds. He also said that he is aware of at least three companies that can identify companies that should be targeted for divestment. In addition, asset managers already should be disclosing to client pension funds the names of companies that pose a global security risk and certifying that no companies that support terrorism are in the asset managers' portfolios.

Issues Concerning the Prosecuting Attorneys' Retirement Fund (SR 26)

Karen Richards, President of the Indiana Prosecuting Attorneys Council, asked the Commission to recommend equalizing the prosecutors' and the judges' pension benefits. She introduced Steve Johnson, Executive Director of the Indiana Prosecuting Attorneys Council, to present the specific changes being proposed.

Mr. Johnson outlined the following proposals (Exhibit 1):

(1) Eliminate contributions to the Prosecuting Attorneys' Retirement Fund (Fund) for a Fund member who completes 22 years of service.
(2) Reduce from 0.25% to 0.1% per month the factor used to adjust a Fund member's benefit when a Fund member chooses to retire before reaching age 65.
(3) Prorate benefits to include partial years of service.
(4) Change the eligibility criteria for a disability benefit to include a disability rendering a Fund member unable to perform the duties of prosecutor.
(5) Align the Fund's disability benefit with the disability benefit received by a member of the Judge's Retirement Fund by:
  (A) allowing a prosecutor with less than five years of service to receive a disability benefit;
  (B) using the same salary replacement percentages to compute a disability benefit; and
  (C) prorating the disability benefit to include partial years of service.
(6) Increase the minimum death benefit from $7,000 to $12,000.
(7) Include the county supplement paid to a Fund member in the total salary

used to compute a Fund member's retirement or disability benefit.
(8) Change the definition of salary used to compute a Fund member's benefit to the salary currently being paid for the position that the Fund member held at separation from service (rather than the salary paid to the Fund member at separation from service). Mr. Johnson requested that this change apply only prospectively.

Mr. Johnson also suggested a $2.00 increase in the court filing fees to pay for these proposals.

Amy Levander Flack of Krieg DeVault, representing the Indiana Prosecuting Attorneys Council, presented a chart showing the increase in projected future payments from the Fund assuming that Proposal 8 (change in the definition of salary used to compute a Fund member's benefit) is adopted (Exhibit 2). She noted that, because the Fund is actuarially prefunded, this chart is for illustrative purposes only and will not be part of the fiscal impact analysis. The proposed $2.00 increase in court filing fees will cover the cost of the benefit changes being proposed, not the Fund's current unfunded actuarial liability.

Ms. Flack also reported that the Indiana Prosecuting Attorneys Council has requested a clarification as to whether the amount that must be appropriated from the state general fund to the Fund under IC 33-39-7-23 is the actual cost or the actuarial cost.

Doug Todd, Senior Actuary, McCready and Keene, Inc., explained the Fund's current funding status and the actuarial cost of the benefit improvements being proposed. He reviewed his letter of August 28, 2008, to Steve Johnson (Exhibit 3), which showed the fiscal impact of each proposal and the cumulative impact to the Fund of all of the proposals, which would be an increase of $14,553,000 in the unfunded liability, an increase of $2,115,300 in the annual funding, and an increase of 11.44% in the annual funding as a percentage of pay.

The Chair indicated that this would be a topic for discussion at the Commission's next meeting.

Misclassification of Employees (HB 1269-2008)

Kelly Pinkham, Research Associate, Department of Economics, University of Missouri-Kansas City, provided an overview of the economic costs of employee misclassification (Exhibit 4). He also reviewed research on the subject that was performed in Illinois, funded by the National Alliance for Fair Contracting, and distributed by the Chicago Area LECET office (Exhibit 5). Finally, he presented the implications of his research findings for Indiana. In addition, he provided to the Commission a copy of his May 8, 2007, testimony to the joint public hearing of the Subcommittee on Income Security and Family Support and the Subcommittee on Select Revenue Measures, U.S. House Committee on Ways and Means, on the effect of the misclassification of workers as independent contractors (Exhibit 6).

Mr. Pinkham defined employee misclassification as the situation in which an employer treats a worker as an independent contractor when the worker would otherwise be a wage or salaried employee. If an employee is classified as an independent contractor, the employer does not pay various employee-based payroll costs (such as Social Security, unemployment insurance, and worker's compensation insurance), and the worker is not fully protected under minimum wage, overtime, worker's compensation, unemployment insurance, collective bargaining, and other employee-based laws.

Mr. Pinkham argued that the Commission should care about this issue, because free markets require fair markets. An employer that misclassifies workers as independent contractors avoids the costs associated with employees, thereby undermining the competitive bidding process and shifting those costs to employers who appropriately classify their workers. He also presented research indicating that an employer that violates labor standards is more likely to jeopardize the public's safety by not complying with construction standards. He stated that different definitions of independent contractor used by various state agencies (Department of Revenue, Worker's Compensation Board, Department of Labor, and Department of Workforce Development) contribute to lax or uncertain enforcement of existing work place regulations.

Mr. Pinkham recommended that enforcement efforts target habitual, systematic violators. An examination of independent contractors by industry showed that the construction sector accounted for 22% of all independent contractors, the highest level of all industries examined, and a 42% increase in the use of independent contractors occurred from 2001 to 2002. The percentage of employers in all industries misclassifying workers ranged from 9% in New Jersey to 42% in Connecticut.

Mr. Pinkham described the scope and methodology of studies of this issue, pointing out data collection difficulties because of state differences in the type of data collected, the definitions of independent contractor used, and the extent to which audits are random versus targeted.

In Illinois, in 2005, 19.5% of audited employers had misclassified workers. Eighteen percent of the employers were responsible for 29% of the misclassified workers. The national trend for the rate of misclassification has increased 21% between 2001 and 2005. Extrapolating the Illinois data to Indiana, Mr. Pinkham estimated that Indiana's misclassification rate is between 10% and 18%. At a 10% rate of misclassification, Indiana would have over 15,000 employers statewide and over 1,600 employers in construction misclassifying workers. At an 18% rate of misclassification, Indiana would have over 27,000 employers and over 2,900 construction employers using misclassified employees. He also estimated losses to Indiana as the result of misclassification: (1) $20 to $26.1 million per year to Indiana's unemployment insurance system; and (2) $70.6 to $117.7 million in lost state income taxes. He discussed probable lost worker's compensation premiums. The cost of worker's compensation is the single most dominant reason why employers misclassify workers. The health system also bears direct and indirect economic costs of misclassification, and misclassification affects construction site safety.

In response to Commission member questions, Mr. Pinkham suggested that Indiana address the misclassification problem by: (1) encouraging data sharing among state agencies; (2) standardizing the definition of independent contractor; (3) performing targeted audits of repeat offenders; and (4) providing meaningful penalties. He discussed efforts undertaken by other states to deal with the issue, including those in Kansas, Illinois, and New York. Kansas created a website to receive anonymous tips, provided outreach and education to contractors, and increased the number of inspectors/auditors. Illinois created a presumption that workers are employees, unless the employer provides sufficient evidence to the contrary. New York created a strike force that has undertaken unannounced audits.

Fiscal Impact of Authorizing Local Units of Government to Appoint or Reappoint Police Officers and Firefighters Who Are At Least 36 Years of Age

Mr. Todd presented his fiscal analysis of a proposal to increase from 36 to 40 the maximum hiring age of the 1977 Police Officers' and Firefighters' Pension and Disability

Fund (1977 Fund) (Exhibit 7). Using the same actuarial funding methods and actuarial assumptions used for the January 1, 2007, actuarial valuation, the increase in the annual cost is $1,390,000, and the increase in the annual cost as a percentage of pay is 0.25%. There is no increase in the unfunded accrued liability, and no decrease in the funded status.

Mr. Steven Barley, Chief Operating Officer and Deputy Director of the Public Employees' Retirement Fund (PERF), reviewed the results of a survey that PERF conducted to determine how other states address this issue: one state has a maximum hiring age of 34 for firefighters only; several states have no maximum hiring age; and other states allow local units to set a maximum hiring age.

Matt Brase, Director of Governmental Relations, Indiana Association of Cities and Towns (IACT), reinterated his earlier testimony that urged caution for any proposal creating a fiscal impact on cities and towns. In response to a question from Senator Tallian about allowing local units to set a maximum hiring age, Mr. Brase responded that the 1977 Fund is a statewide fund, so that one jurisdiction setting an older maximum hiring age affects all other local units in the 1977 Fund.

Mr. Tom Hanify, President of the Professional Firefighters of Indiana, supports this proposal if a local unit can make the 1977 Fund whole when the unit hires a person older than 36. Mr. Tom Miller, President of the International Professional Firefighters Union, mentioned federal Age Discrimination in Employment Act (ADEA) concerns.

Indiana State Teachers' Retirement Fund (TRF) Follow-up Action Items

Julia Pogue, TRF's Chief Financial Officer, presented information concerning Sudan divestment, the fiscal impact of members vesting on Day 1(immediate vesting), and the unfunded liability projection for the pre-1996 account (Exhibit 8).

TRF completed its divestment of scrutinized companies by June 30, 2008. The amount divested was $44.3 million, less than 0.5% of total assets.

If its members were immediately vested, TRF estimates that the present value of future benefits would increase $8.9 million: $1.8 million for the pre-1996 account and $7.8 million for the 1996 account. This estimate assumes that only current non-vested active members would become vested, a 7.5% average annual investment return, and a 1.5% annual cost of living adjustment. TRF also estimates that annual administrative costs would increase by $1.0 to $1.5 million for processing the additional applications and disbursements.

TRF also projects that the pre-1996 account will be fully funded by 2030, assuming the state maintains 106% year over year appropriations, the $30 million per year lottery contribution continues, and the Pension Stabilization Fund earns an annual average investment return of 7.5%.

Tax-Free Death Benefit for the 1977 Fund

Mr. Barley reported on PERF's research as to the options for making the receipt of the 1977 Fund's death benefit tax-free (Exhibit 9). PERF contacted three major insurance carriers about underwriting a group life insurance policy for the benefit, but none of the carriers was interested in doing so. If anyone other than the member pays the premium, PERF is required to issue Form 1099s, and the member is required to pay income taxes on the amount of the premium. PERF estimates that the approximate annual premium cost for a $12,000 benefit is $1.4 million and for a $10,000 benefit is $1.1 million. PERF also estimates that the administrative costs would be approximately $1 million to make system changes and $200,000 to mail Form 1099s. PERF also determined that the current death benefit would be reduced from $12,000 to $6,240, if PERF were to net the premiums and the taxes from the benefit in order to make the proposal cost neutral.

Mr. Todd reviewed the fiscal impact to the 1977 Fund of the various proposals (pages 2-4, Exhibit 9): (1) if the insurance premiums are paid by the 1977 Fund, the increase in the annual funding is $670,000; (2) if the insurance premiums are paid by the fund members outside of the 1977 Fund, the 1977 Fund would experience an annual cost savings of about $730,000; and (3) if the death benefit is reduced to pay the insurance premium, the annual funding would not change, but the death benefit would be reduced from $12,000 to about $6,240. Currently 0.125% of the employer contribution pays for the death benefit.

Mr. Hanify expressed his appreciation to PERF and to the Commission for looking at this issue. Senator Kruse asked Mr. Brase whether IACT members would support an increase in this benefit to allow survivors of 1977 Fund members to net a $12,000 benefit. Mr. Brase indicated that he would need to check with his members in order to answer Senator Kruse's question.

Fiscal Impact of a Minimum Cost of Living Adjustment for the 1977 Fund

Mr. Todd reviewed his analyses of the effect on the 1977 Fund of providing a minimum cost of living adjustment (COLA) of 2.0% or 2.5% annually. Current Indiana law provides for a COLA based on the Consumer Price Index, not to exceed 3% annually. There is no minimum COLA.

For a 2.0% COLA, the increase in the unfunded accrued liability is $15,040,000, the increase in the annual cost is $2,020,000, the increase in the annual cost as a percent of payroll is 0.3%, and the decrease in the funded status is from 108.0% to 107.4% (Exhibit 10). For a 2.5% COLA, the increase in the unfunded accrued liability is $45,710,000, the increase in the annual cost is $6,140,000, the increase in the annual cost as a percent of payroll is 1.1%, and the decrease in the funded status is from 108.0% to 106.1% (Exhibit 11).

Mr. Todd also determined that the average COLA paid by the 1977 Fund from 1978 to the present has been 2.73%. The cost of the COLA is borne by the local units that participate in the 1977 Fund.

Mr. Hanify testified that this proposal is the most important one to his members.

Senator Kruse asked Mr. Brase to have IACT members prioritize the proposals funded by local units for the Commission's next meeting. He also asked Mr. Todd to prepare fiscal analyses for a 1% and 1.5 % minimum COLA for the 1977 Fund.

Fiscal Impact of Increasing the Surviving Spouse Benefit for the 1977 Fund

Mr. Todd presented fiscal analyses for proposals to increase the surviving spouse benefit from 60% to 75% or 80% of the 1977 Fund member's benefit. Currently, Indiana law provides a surviving spouse benefit of 60% of the benefit the member was receiving, or was entitled to receive, at the time of the member's death, for a member who does not die in the line of duty.

Increasing the surviving spouse's benefit to 75% of the 1977 Fund member's benefit would increase the unfunded accrued liability by $64,450,000, increase the annual cost by

$8,200,000, increase the annual cost as a percent of payroll by 1.5%, and decrease the funded status from 108.0% to 105.4% (Exhibit 12).

Increasing the surviving spouse's benefit to 80% of the 1977 Fund member's benefit would increase the unfunded accrued liability by $85,940,000, increase the annual cost by $10,930,000, increase the annual cost as a percent of payroll by 1.90%, and decrease the funded status by 108.0% to 104.6% (Exhibit 13).

Mr. Hanify testified that this proposal is also an important one for his members. He requested an opportunity to comment on this topic during the next Commission meeting, after he has reviewed Mr. Todd's fiscal analyses.

Senate Enrolled Act 501-2007 Retirement Medical Benefits Account Update

Christopher A. Ruhl, Director, Indiana State Budge Agency, presented the 2008 update concerning the retirement medical benefits account administered by the Budget Agency (Exhibit 14). Mr. Ruhl briefly reviewed the background of, the participants in, the contributions to, the disbursements from, and the actions taken by the Budget Agency to implement the account. He provided the first year (state fiscal year 2008) facts and figures for the account. There are 725 retired participants with an average contribution per participant of $25,726, and total claims for all retired participants of $507,496. In addition, 34,829 active participants received a credit averaging $1,090 on June 30, 2008. $585,061 in investment earnings was credited to participants' subaccounts.

Mr. Ruhl provided information about the first year fiscal impact of the account. For the current biennium, the General Assembly appropriated $23 million annually from the general fund from cigarette tax revenues under the Healthy Indiana Plan. The actual cost of the account in fiscal year 2008 was $56 million: $38 million in annual contributions for active participants and $18 million in bonus contributions for retired participants. The administrative costs were $100,539, paid from investment earnings of $700,000.

In 2008, the General Assembly expanded the use of amounts in the account to include the purchase of coverage in the state's self-insured health plans. Expenses for claims by retired participants in the state plans are significantly greater than the premium charged the retirees, creating what actuaries call an "implicit subsidy". The state and active employees fund this subsidy over time through the payment of higher premiums. The current "implicit subsidy" is estimated at $35 to $76 million, the actual amount depending upon how many retired state employees elect to participate in the state's plans. The additional amount required to actuarially fund the " implicit subsidy" is $4 to $9 million annually. The state is required to report this unfunded liability under GASB 45.

Finally, Mr. Ruhl outlined the current issues facing the retirement medical benefits account. The first issue is the cost. The fiscal year 2008 unfunded liability of $33 million was paid by a one-time allocation of general fund dollars from the state's personal services contingency fund. Two-thirds of the account's current cost is the annual contribution for active participants. This cost may come down slightly over time as employees leave state service and forfeit their subaccount balances. However, the cost of the annual contribution for active participants is likely to exceed the $23 million annual appropriation made for the last biennium.

A second cost issue is the implicit subsidy, which was not considered by the General Assembly when it expanded the use of the account to include the state's self-insured health plans.

A third issue is the lack of cost savings. The account was sold on the basis that the bonus contributions would encourage a substantial additional number of state employees to retire, thereby providing operating savings that could be used by state agencies to pay for the cost of the account. In fiscal year 2008, the state actually had fewer retirements (725) than its historical average of 750.

In response to a question from Senator Kruse, Mr. Ruhl responded that the Budget Agency is uncertain as to whether it will request additional amounts to fund the account in the next budget.

Section 401(h) Account Update

Mr. Barley provided an update concerning the Section 401(h) account administered by PERF. In July 2007, PERF submitted an approval request for the 401(h) account to the Internal Revenue Service (IRS). In June 2008, the IRS notified PERF that, because the request had been submitted off-cycle, the IRS would not address it until all of the on-cycle requests were completed. PERF was advised that withdrawing and resubmitting the request in January 2009, as part of PERF's on-cycle request, would result in a quicker IRS review. PERF is in the process of finalizing its on-cycling filing, including the Section 401(h) account approval request. Implementation of the Section 401(h) account will not occur until PERF receives IRS approval.

Fiscal Impact of Reducing the PERF Vesting Period from Ten to Eight Years

Mr. Todd discussed his fiscal analysis of a proposal that PERF provide benefits to a member with at least eight years of creditable service (Exhibit 15). Currently, a PERF member with at least ten years of creditable service is entitled to receive a benefit from PERF at retirement.

For the state, the proposal increases the unfunded accrued liability by $850,000, increases the annual cost by $1,000,000, increases the annual cost as a percent of payroll by 0.066%, and does not change the funded status, which is 98.2%.

For political subdivisions, the proposal increases the unfunded accrued liability by $2,650,000, increases the annual cost by $2,108,000, increases the annual cost as a percent of payroll by 0.074%, and does not change the funded status, which is 98.2%.

Phil Conklin, Legislative Representative, Retired Indiana Public Employees Association (RIPEA), testified in support of reducing PERF's vesting period (Exhibit 16). In May 2008, RIPEA contacted all 119 mayors in Indiana to determine their views on this change. RIPEA received 67 responses (none from Lake County). 85% of the responders favored reducing the vesting period.

Increase in the PERF Multiplier

Mr. Conklin also briefly testified in support of a proposal to allow an employee to use all or a portion of PERF's 3% mandatory employee contribution to purchase an additional multiplier above the current 1.1%, with PERF matching 25% to 50% of the amount designated by the employee (Exhibit 16). Mr. Conklin suggested that the maximum multiplier an employee could purchase should be 1.67%. With a 1.67% multiplier, an employee with 30 years of creditable service would receive a benefit equal to approximately 50% of the employee's average compensation. The Chair agreed to a further discussion of this item at the Commission's next meeting.

David Larson, Indiana State Employees Association, suggested that the additional money that might be used to reduce PERF's vesting period be instead directed to increasing the multiplier or for retiree health care benefits.

Factors Used in COLA Determinations for PERF, TRF, and the State Police

Because of the time, the Chair deferred consideration of this item until the next Commission meeting.

Next Meeting Date

The Chair announced that the third meeting of the Commission will be held on Thursday, October 2, 2008, at 12:30 p.m. in the Indiana Supreme Court Chamber. The agenda for the meeting will include police and firefighter disability pensions and age discrimination issues. Funds for a fourth meeting have been requested. If the request is granted, the Commission's fourth meeting will be scheduled for October 15th.

The meeting was adjourned at 3:30 p.m.